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No. 218

# In the Supreme Court of the United States

OCTOBER TERM, 1964

LEONARD HYATT AND MAUDIE HYATT,
*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

## BRIEF FOR PETITIONERS IN REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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### REPLY TO RESPONDENT'S ARGUMENT

The government has distorted, no doubt without purpose, the issue in this case in its brief in opposition to the petition for a writ of certiorari. Therefore, we are compelled to reply.

The question presented is whether the sale of a general agency contract with a mutual life insurance

company is taxable as capital gain or as ordinary income. This question is deserving of review because it is involved in the sale of many common and well recognized commercial arrangements, such as agency or management contracts, franchise and distributorship contracts, and license agreements. The tax treatment on such sales is now subject to considerable confusion because of conflict among the Circuits and the interpretation by the government of this Court's language in the case of *Commissioner v. P. G. Lake, Inc.*, 356 U.S. 260. For this reason the case is of the utmost importance to the business community.

The government now argues that (Res. 7):

> "[the taxpayer] was paid, at least largely, for what he had already earned, but not yet received, for his services."

There is not one scintilla of evidence in the record of this case to support such an argument, and, moreover, such an issue was not raised by the government in the Tax Court. The petitioner would be the first to admit that the sale of any amounts already earned under the contract, but not yet received, is taxable as ordinary income.

The Findings of Fact and Opinion of the Tax Court show beyond a doubt that the sole item of sale was the general agency contract. The Tax Court's language on this point in its Findings of Fact is (R. 146-147):

> "Hyatt and United Security thereupon executed an agreement on November 8, 1952, which provided, in accordance with the authorization of

> its Board of Directors, that Hyatt would be entitled to receive the $72,375 payment due the company from Western American in consideration for his transfer to United Security of the general agency contract."

The reference to income rights in the contract of sale between Hyatt and United Security was obviously to future or unearned income. There is no evidence in the record nor was the issue raised nor did the Tax Court find, or even suggest, that there had been a sale of income that Hyatt had already earned. The Tax Court's opinion is unmistakably clear that the agency contract was the sole asset that was sold. The language of its opinion so states as follows (R. 149):

> "The United Security general agency contract is the sole item here in question and we are unable to accept Petitioners' contention that it constitutes a capital asset under Section 117 (a)."

Further language of the Tax Court's opinion to the effect that the sale was of a right to future earnings, and not of amounts already earned, is as follows (R. 151):

> "The consideration received by Hyatt by way of assignment from United Security appears to us to be a substitute for the right to receive ordinary income in the form of premiums in the future. Cf. Nat Holt, 35 T.C. 588, on appeal (C.A. 9, July 17, 1961). When Hyatt assigned to United Security the general agency contract, he relinquished his right to receive such compensation thereunder. The company acquired the

> right to receive the regular premium income resulting from ownership of the general agency agreement."

Finally, the Court's concluding language shows that there was no sale of income already earned (R. 151):

> "Therefore, as we view the record here, the amounts totalling $72,375 received by Hyatt from American by way of assignment from United Security were paid for his right to future compensation, not for the acquisition of an income-producing capital asset falling within the ambit of Section 117(a) of the 1939 Code."

The Tax Court's holding that the contract was not a capital asset was based on its interpretation of the Supreme Court's decision in *Commissioner v. P. G. Lake, Inc., supra;* and other cases, which the Tax Court construed to (R. 150):

> "hold generally that amounts received pursuant to the sale or assignment of income-producing contracts are taxable to the assignor as ordinary income."

The issue, therefore, as raised by the Commissioner of Internal Revenue, and presented to the Tax Court, concerns the tax treatment of the assignment of an income-producing contract. The Tax Court held the sale taxable as ordinary income for the reason that the income that would have been produced under the contract in the form of future premiums would have been taxable as ordinary income (R. 151). It is on this point that the issue has been drawn. The case

has never involved income already earned but not yet received.

A second distortion of the record is found in the government's argument (Res. 9) that the right assigned is merely the opportunity afforded by contract to render services and receive payment therefor. If the contract called upon the taxpayer solely to render services, as the government argues, there would have been no dispute. The sale of such a contract would plainly fall outside the defined limits of capital gain treatment. On the other hand, the general agency contract in this case required the taxpayer to furnish substantial amounts of money. This fact is set forth in the Tax Court's Findings of Fact and even recognized by the statement of facts in the respondent's brief. The Tax Court found as a fact that (R. 146):

> "At the time of execution of the general agency contract with United Security on March 8, 1949, the company had no assets and no business. Hyatt furnished the necessary finances, the office, furniture, fixtures, employees, and personal services necessary to build up the business."

Therefore, the government is plainly in error in arguing that (Res. 9):

> "The amount received in consideration is not, in any meaningful sense, a return of capital plus appreciation; rather it is a present substitute for the ordinary income which could have been earned had the contract been performed." [1]

[1] It is to be noted that the government here admits that the consideration Hyatt received on the sale of the contract is a present substitute for future ordinary income rather than for income already earned but not yet received.

In this case there was plainly an investment of moneys to build up the business. It must follow that the consideration received on its sale was for an increase in value in the contract, the sole asset of the business. Therefore, the test for capital gains laid down in *Commissioner v. P. G. Lake, Inc., supra,* has been satisfied. If the consideration on this sale is a present substitute for the ordinary income which could have been earned had the contract been performed, then the same could be said as to the sale of any income-producing contract or property. As stated by the Fifth Circuit in *United States v. Dresser Industries, Inc.*, 324 F. 2d 56:

> "The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income."

The same reasoning was applied by the Second Circuit in *Commissioner v. Ferrer*, 304 F. 2d 125, where it states:

> "We see no basis for holding that amounts paid Ferrer for surrender of his lease of the play are excluded from capital gain treatment because receipts from the play would have been ordinary income. The latter is equally true if a lessee of real property sells or surrenders a lease from which he is receiving business income or subrentals."

In summary, the government has distorted the issue by arguing in the face of the record:

1. That there was a sale of income already earned but not yet received; and

2. The agency contract was merely one to render services.

In fact, the sale was of a contractual right to operate an insurance business. The value of this contractual right increased as the business was built up since the contract was the sole asset which was sold. The business was built up because the taxpayer furnished the necessary finances for its operation.

True, the consideration for the sale of the contract was based on the expected income that could be earned in the future. There was no assurance, however, that any income could be earned in the future. This is the risk that goes with any business. But, the sales price did represent the present worth of expected future earnings. Because of this fact, the Tax Court and the Fifth Circuit have held that the gain is taxable as ordinary income. These courts viewed the sales price as a substitution for the right to receive ordinary income in the future. They have read *Commissioner v. P. G. Lake, Inc., supra,* to mean that the transfer of the agency contract represented the present cash value of ordinary income expected over the life of the contract, and, therefore, the transfer was of a right to receive future income, as represented by the net profits of the operation, rather than the transfer of a capital asset. The basis of this petition

is that these courts have misapplied the doctrine of the decision in *Commissioner v. P. G. Lake, Inc., supra*, and since thousands of commercial contracts, substantially similar to that in this case, are valued and sold on the basis of future earnings, the present confusion plainly calls for resolution by this Court.

2. In part 2 of its Brief (page 10) the government argues that there is no conflict between the decision of the Second Circuit in *Commissioner v. Ferrer, supra*, and the decisions of the Fifth Circuit in *United States v. Eidson*, 310 F. 2d 111, and in the instant case. The government contends that the cases are distinguishable because the taxpayer in *Commissioner v. Ferrer* conveyed an income-producing property and the taxpayer here and in *United States v. Eidson, supra*, conveyed a mere contractual right to receive future income. We are unable to see any distinction, nor did the panel of the Fifth Circuit in *United States v. Dresser Industries, Inc. supra.*[2] In one case, the taxpayer sold a right to produce a play and in the other he sold a contract to operate an insurance business. Both arrangements required financing by the taxpayers. Both arrangements afforded the taxpayers an opportunity for profit and both exposed them to the risk of monetary losses. Both contracts increased in value; and in the instant case, the value of the contract increased

[2] In the Court of Claims case of *H. N. Miller, et al v. United States*, No. 212-59, 5-15-64, 331 F. 2d 854, a similar management contract with a Texas mutual life insurance company was recognized as an income-producing intangible asset.

as the business was built up. Considering the economic realities of each arrangement, what justification is there for taxing one as ordinary gain and the other as capital gain? What sense is there in calling the right to produce the play an "income producing property" and the right to operate an insurance business "a mere contractual right to future ordinary income," and allowing these labels to determine tax liabilities? Plainly, both sales should be taxed as ordinary gains or both should be taxed as capital gains. In each case, however, the government has contended in the Courts that because the rights would produce ordinary income in the future, the consideration for their sale should be taxed as ordinary income. In both cases this Court's language in *Commissioner v. P. G. Lake, Inc., supra,* was cited by the government in support for such a proposition. The Second Circuit in *Commissioner v. Ferrer, supra,* rejected the government's argument and the Fifth Circuit in *United States v. Eidson, supra,* and in the instant case, accepted it. This is the nub of the conflict. It is indeed real. Because of this conflict, the owner of a management contract, a franchise agreement, a distributorship contract, or an exclusive agency has no certainty as to the taxes he will be called upon to pay in the event of a sale of his interest. The decision of the Fifth Circuit would plainly call for a tax on ordinary gain. The Second Circuit would allow a capital gains tax. This is the state of the confusion. Many thousands of commercial ar-

rangements are involved. The conflict on this important issue affecting the plans of thousands of individuals plainly calls for resolution by this Court.

## CONCLUSION

It is respectfully submitted that this petition for a writ of certiorari should be granted.

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